

**IN THE HIGH COURT OF NEW ZEALAND  
AUCKLAND REGISTRY**

CIV 2004-404-1333

Hearing: 30 June, 1-4, 7-10, 14-18, 28-31 July, 4-7 August 2008

Counsel: JA Farmer QC, GM Coumbe, A Wing, K Tahana, SD Glass and JS McHerron for Plaintiff  
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Judgment: 9 October 2009

## JUDGMENT OF RODNEY HANSEN J AND PROFESSOR MARTIN RICHARDSON

*This judgment was delivered by me on 9 October 2009 at 1.00 pm  
pursuant to Rule 11.5 of the High Court Rules.  
Registrar/Deputy Registrar*

Date: .....

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## **Introduction**

[1] The Commerce Commission (the Commission) claims that Telecom has used its dominance in the telecommunications industry to achieve an unlawful and unfair advantage over other firms engaged in data transmission.

[2] The telecommunications network inherited by Telecom from the Post Office when the telecommunications industry was privatised in 1989, is used to transmit information which has been converted into digital format. As competitive markets in many sectors of telecommunications emerged during the 1990s, rival telecommunications service providers (TSPs)<sup>1</sup> sought access to Telecom's network in order to provide their own data transmission service. This was generally in less densely populated areas where it was uneconomic for TSPs to replicate Telecom's ubiquitous network. In order to offer a competing data transmission service the TSPs had to acquire the right to connect to potential customers through Telecom's network. That connection – between the customer's premises and the TSP's own network – is known as a data tail.

[3] The Commission alleges that over the period 1 December 1998 until late 2004, the wholesale price charged by Telecom to other TSPs for access to data tails was so high, relative to Telecom's retail price, as to cause what is known as a "price squeeze". A price squeeze occurs when a dominant vertically integrated supplier sets prices in the upstream wholesale market in a manner that prevents equally or more efficient competitors from profitably operating in the downstream retail market.

[4] The Commission claims that Telecom's conduct contravened s 36 of the Commerce Act 1986 (the Act) in that it used its dominant position in the relevant wholesale market for data tails (and, from 26 May 2001, the substantial degree of power it had in that market) to set wholesale prices and other terms on which it supplied data tails to TSPs at a level which would prevent or deter existing or

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<sup>1</sup> The telecommunications industry makes frequent use of acronyms. A glossary of acronyms and abbreviations used in this judgment is attached as Appendix 1.

potential TSPs from competing in the relevant retail market and deter those TSPs from competing in the wholesale market for ‘backbone’ transmission services.

[5] The Commission seeks a declaration and a pecuniary penalty which, by virtue of the limitation provision in s 80(5) of the Act, is limited to the period from 18 March 2001. There is an issue as to whether any declaration may relate to Telecom’s conduct before that date.

[6] Parts of the evidence adduced in the proceeding is subject to confidentiality orders and undertakings. Any confidential information referred to in this judgment will be enclosed in square brackets. The confidential information will be included in copies of the judgment distributed to counsel but omitted from any copies accessible to the public.

### **Legal basis for claim**

[7] The Commission’s claim includes periods that precede and follow the amendments to s 36 of the Act which came into effect on 26 May 2001. Before then, s 36 provided:

- 36. Use of dominant position in a market –** (1) No person who has a dominant position in the market shall use that position for the purpose of –
- (a) restricting the entry of any person into that or any other market; or
  - (b) preventing or deterring any person from engaging in competitive conduct in that or any other market; or
  - (c) eliminating any person from that or any other market.

[8] From 26 May 2001, s 36 relevantly provides:

**36. Taking advantage of market power –**

...

- (2) A person that has a substantial degree of power in a market must not take advantage of that power for the purpose of –
- (a) restricting the entry of a person into that or any other market; or
  - (b) preventing or deterring a person from engaging in competitive conduct in that or any other market; or
  - (c) eliminating a person from that or any other market.

[9] The Commission submits that the test of substantial degree of power in a market was intended to establish a lower threshold than dominance. It will not be necessary for us to consider the issue. It is accepted that Telecom had both dominance and a substantial degree of market power in the wholesale market. For convenience we will use the term “dominance” as also encompassing a firm possessing a substantial degree of market power unless it is necessary to distinguish between the two concepts.

[10] The 2001 amendment replaced “use” with “take advantage of”. It is accepted that no change to the meaning of s 36 resulted. References to “use” of dominance accordingly should be read if necessary as including taking advantage of a substantial degree of market power.

[11] The area of contention focuses on the second and third issues raised by s 36 – whether Telecom’s position of dominance was used and, if so, whether it was used for one or more of the proscribed purposes. The term “use” requires that a causal relationship is shown between the conduct alleged against the dominant firm and its dominance or market power – *Carter Holt Harvey Building Products Group Limited v Commerce Commission* [2006] 1 NZLR 145 (PC) at [51]. The causal link between dominance and the impugned conduct is shown by the counterfactual test. That requires, in the context of this case, an examination of whether Telecom acted in a way in which a hypothetical firm, not in a dominant position but otherwise similarly placed, would have acted – *Telecom Corporation of New Zealand Limited v Clear Communications Limited* [1995] 1 NZLR 385 (PC) at 403; *Carter Holt Harvey Building Products Group Limited v Commerce Commission* at [29] and [52]. If

Telecom has acted in a way in which it could not have acted if it had not been dominant, it will have used its dominant position. As we will discuss in more detail later, in cases where the conduct in issue concerns the pricing of a dominant vertically integrated provider of network infrastructure and services, an economic model is employed. The application of that model in the market in which Telecom operated is at the heart of this case.

[12] The third issue – whether dominance has been used for a proscribed purpose – may be inferred from evidence that the conduct had an anticompetitive effect or shown by direct evidence of what the conduct was intended to achieve. The Commission relies on evidence in both categories to prove purpose.

### **The development of data transmission services**

[13] The transmission of data between geographically remote locations has been achieved by adaptations to the basic telephone system, the Public Switched Telephone Network (PSTN). The PSTN has two main elements. The core or backbone of the system comprises the exchanges and the trunk lines which connect them. The connection of the core with customers' premises is the access component, known as the local access network or local loop. Historically the local network comprised pairs of copper wires. Fibre optic cable has now replaced copper in many of the local access lines. They are linked to an exchange where, for the purpose of voice calls, switches enable a call from one telephone number to be connected to another number for the duration of the call.

[14] The PSTN was used for the transmission of basic data services such as telex and fax, but the speedy and efficient transmission of high volumes of data by converting the data into digital format required additional technology. The basic components are:

- A network terminating unit (NTU) located at the customer's premises. The NTU converts and transfers data into digital format and receives and converts data transmitted in digital format.

- Multiplexers, which are sited at selected exchanges (or at a roadside cabinet). They aggregate individual data circuits. The aggregated stream is then transmitted to switches at telephone exchanges.
- Digital cross-connect switches (DCS) which separate individual data streams from the aggregated flows coming in from a multiplexer and route them through the core or backbone part of the network to connect with another DCS near the destination for the data. The data is then delivered through another multiplexer to its destination, the NTU at the customer's premises.

[15] The entire connection between the two premises of a customer is known as an end-to-end connection. In the first platform or system used by Telecom to transmit data in digital format, the Digital Services Transport Network (DSTN), each end-to-end connection was a dedicated circuit: it was a permanent connection between the two points with a fixed transmission capacity and was never shared with any other user. Such circuits are said to provide a constant bitrate (CBR) service. The bitrate is the speed at which data is transmitted. Industry usage refers to speeds between 64kbps and 2Mbps as high speed, speeds lower than that as low speed and speeds higher as very high speed. The typical DSTN connection was low speed – 64kbps – and, in fact, we heard that a DSTN NTU could not operate over copper at more than 128kbps. A CBR service ensures that the speed and quality of transmission is constant and assured. There are, however, associated inefficiencies. When a user is not using its full allocated capacity, additional capacity in the circuits cannot be used to meet the needs of other users.

[16] A CBR service is to be distinguished from a variable bitrate (VBR) service, which is provided when circuits are shared by a number of users. The speed of transmission then will depend on the volume of traffic; at peak times service will be slower. A VBR service offers a Committed Information Rate (CIR) and a Peak Information Rate (PIR). A TSP guarantees the minimum speed of the CIR while offering the potential for the higher PIR at off-peak times.

[17] A VBR service was introduced by Telecom with its Frame Relay (FR) network installed in 1994. It enabled data to be transmitted at higher speeds and a

circuit to be connected to any customer on a switch: any-to-many rather than point-to-point transmission. This was achieved by the transmission of data in packets, known as frames. FR built on a much older packet switched network, which was used for the early EFTPOS service.

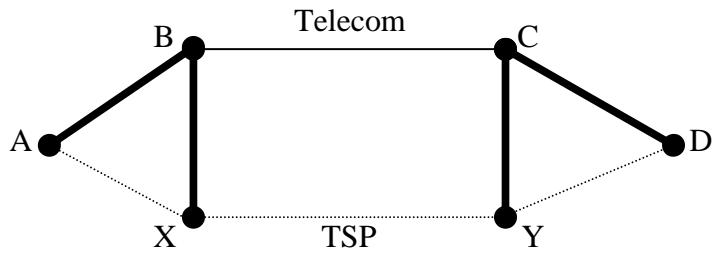
[18] In 1997 Telecom introduced a new network, the Asynchronous Transfer Mode (ATM), which enabled packets (now called cells) to be tagged with different service qualities and carried with different service guarantees. High quality cells travel fast and with little loss; medium quality cells are not quite as fast and may occasionally suffer some loss or delay; and low quality cells are carried on a “best efforts” basis. This permitted the ATM network to carry different types of traffic according to the service quality required. Very high speed data transmission services could be offered on the ATM through fibre connections but high speed services were also provided, initially across the DSTN backbone, albeit with asymmetric up-and-down-load speeds until 2001, when digital subscriber line (DSL) technology and DSL access multiplexers (DSLAMs) enabled direct access to the ATM backbone. FR services were progressively migrated onto the ATM network, which was then able to provide VBR frame relay services and CBR services such as Digital Data Service (DDS).

[19] In the mid-1990s Telecom began introducing a connectionless technology known as the Internet Protocol (IP) technology. Since 2000 it has supported an increasing range of data communication services.

[20] During the 1990s other TSPs rolled out limited networks and network components. Both Clear Communications Ltd (Clear) and Telstra Saturn Limited (Telstra) installed a fibre backbone network connecting some of the main centres. Both companies, and a number of other TSPs, constructed fibre networks in the CBDs of major cities. However, in non-major CBD areas Telecom had the only local access network or the only access network capable of transmitting business data. TSPs who wished to compete in the retail market for end-to-end high speed data transmission services were dependent on access to Telecom’s access network in non-major CBD areas.

## Data tails

[21] As mentioned earlier, a data tail is the connection between a customer's premises and the TSP's own network. It connects the customer's end-use point on a data circuit and the nearest point at which a TSP, other than the owner of that part of the circuit, can take delivery of the data signal. The following diagram illustrates the concept:



[22] In this diagram, an end-to-end circuit connects a customer's premises at point A to another of their premises at point D. The links AB and CD represent connections from the physical premises to an exchange building and the links BX and CY represent connections from an exchange to a point at which a rival TSP could pick up the transmission. This is known as a point of presence (POP). The links BC and XY represent the core or backbone network transmissions of Telecom and the rival TSP respectively. In this set-up the heavy lines ABX and DCY are data tails: the links from the customer's location to the point at which the TSP can take up the signal.

[23] If the customer were served by Telecom, the circuit would be represented by ABCD. If the customer were served by a TSP and both data tails were provided by Telecom the circuit would be ABXYCD. If the TSP provided one tail itself (because it had its own access network at one end of the circuit or obtained it from a provider other than Telecom) the circuit would be AXYCD or ABXYD, depending on which tail was leased. It is also open to a TSP to simply lease the entire circuit ABCD from Telecom and re-sell it to the consumer.

## **Telecom's pricing**

### *Retail pricing*

[24] Before 1999, Telecom's retail prices for end-to-end data services were contained in Telecom's List of Charges (TLoC). In addition to a one-off installation charge, there was a monthly charge that normally included:

- A charge for access to the customer's premises at each end of the service.
- A charge for transmission between the two data exchanges to which the premises were connected. The charge varied according to the distance the data was carried.
- Incidental charges for service delivery and the like.

Access and transmission charges varied according to the speed of the circuit – the higher the speed the higher the charge.

[25] In 1999, Telecom introduced new retail pricing known as Streamline. It introduced significantly lower prices. Among the changes were:

- Reduced prices for VBR (frame relay) services to around 70% of the price of DDS services (a CBR service).
- A reduction in the number of steps in the transmission component of the pricing methodology to local and national.
- Changing access speeds to provide a choice of two only – 128 kbps and 2 Mbps.

Streamline became and, we were told, remains Telecom's price book for data services.

### *Wholesale pricing*

[26] Initially, between 1996 and 1997, TSPs could purchase data connections at TLoC prices less 6% pursuant to the terms of their inter-connection agreements with Telecom. Under pressure from the TSPs, a wholesale pricing regime was introduced known as WIN (Wholesale Integrated Network). Telecom offered TSPs discounts of between 15 and 30% off TLoC prices. Discounts were higher in major CBD areas. TSPs were able to compete under WIN pricing. Clear, for example, increased its market share from [ ]% in early 1997 to [ ]% by the end of 1998.

[27] Initially, new wholesale prices were not offered to TSPs following the introduction of Streamline retail prices. TSPs continued purchasing data tails at TLoC less 15-30% under WIN pricing. The Commission alleges that this was the beginning of the price squeeze.

[28] It was some months before Telecom introduced new wholesale prices. The new offer became known as Carrier Data Pricing (CDP). Typically it provided TSPs with a discount of between 6 and 15% off Streamline pricing. The Commission says that under CDP, wholesale prices did not fall commensurately with the large reductions brought about by the introduction of Streamline retail prices; the prices of two data tails in most instances were above the retail end-to-end price charged by Telecom to its customers. The Commission says that, in continuing to price data tails in exactly the same way as an end-to-end service, Telecom was furthering a deliberate pricing policy driven by two main goals:

- To turn rivals into mere resellers of Telecom's product and, by that means, to grow the market; and
- To encourage competitors to view Telecom as the network of choice. That would not only keep them as resellers but discourage them from developing their own networks.

[29] TSPs were initially resistant to the CDP offer. Telstra, Clear and others lodged complaints with the Commission in 1999 and took steps to respond

competitively. However, the Commission claims they were unable to compete profitably with Telecom and some TSPs were driven from the market.

[30] In September 2000, Telecom and Clear reached a settlement of a range of issues. Their agreement included the provision of Telecom's high speed data transmission (HSDT) services at a [ ]% discount on market prices. Comparable agreements were reached with other TSPs, including Telstra, and a further agreement entered into on the merger of Clear and Telstra into TelstraClear. We discuss later the implications of these settlements for the Commission's claim.

[31] The Commission says Telecom's anti-competitive pricing policies for data tails did not come to an end until June 2004, when Telecom gave undertakings that it would introduce an Unbundled Partial Circuits (UPC) service to TSPs at cost-based pricing by 30 September 2004. This led soon afterwards to UPC pricing agreements with TelstraClear and others.

[32] These agreements marked the end of a process which commenced in September 2000, when a Ministerial inquiry into the New Zealand telecommunications sector reported. Chaired by Mr Hugh Fletcher (hence known as the Fletcher Inquiry), the report – *Ministerial Inquiry into Telecommunications; Final Report, 27 September 2000* – recommended that certain services, including data tail access, be designated immediately. This recommendation was not implemented in the Telecommunications Act 2001. However, by s 64 the Commission was required to report within 20 months on whether access to the unbundled elements of Telecom's local loop network and the unbundled elements of, and interconnection with, Telecom's fixed Public Data Network should be a designated service or a specified service under the Act. At a conference held by the Commission, Telecom announced its intention to introduce a UPC service, to be priced at a level at which an efficient access-seeker could compete at retail. The Commission recommended against unbundling in its final report dated 22 December 2003, having regard to, among other things, Telecom's announcement which presaged the later undertakings and agreements.

## **Market definition**

[33] The first step to an analysis of Telecom's dominance is to define the markets in which it operates. The purpose of market definition is to identify the area or areas of close competition and to identify the constraints which operate on participants. It is necessary to a determination of whether Telecom was dominant in a relevant market and whether any use of dominance was for an anti-competitive purpose.

[34] Markets must be defined by reference to s 3(1A) of the Act which provides:

Every reference in this Act, except the reference in section 36A (2)(b) and (c) of this Act, to the term "market" is a reference to a market in New Zealand for goods or services as well as other goods or services that, as a matter of fact and commercial common sense, are substitutable for them.

[35] The Commission alleges the relevant markets are:

- The national retail market for end-to-end high speed data transmission services.
- The wholesale market outside major CBD areas for data tails where major CBD areas are defined as those:
  - a) Served by multiple telecommunications networks (owned by both Telecom and other network operators) capable of being used to provide retail high speed data transmission services;
  - b) With relatively low barriers of entry by reason of sufficient aggregation of demand relative to minimum viable scale.
- The national wholesale market for backbone services.

[36] In its third amended statement of defence, Telecom admitted there was a national retail market for end-to-end high speed data transmission services, while denying the particulars pleaded by the Commission. It denied the existence of the remaining two markets.

[37] In evidence for Telecom, Professor Jerry Hausman suggested that the product dimension of the retail market should not be confined to data transmission services, as sales were frequently made as part of a package of telecommunication products which included voice and internet services. The Commission objected to the introduction of his evidence as inconsistent with Telecom's pleaded position. At the time Mr Shavin QC intimated that he would, if necessary, seek to amend Telecom's defence to expand the product component of the retail market. No such application was made and we infer that Telecom is content with its pleaded position.

[38] In our view, the pleaded definition, in any event, provides greater assistance to the analysis we are required to make. The evidence is that in many cases data services were sold separately. Neither internet nor voice services are, as a matter of fact and common-sense, substitutable for data transmission services. In terms of s 3(1A) of the Act, a separate market for data transmission services is appropriate.

[39] The two wholesale markets are distinct but related. The core network or backbone has multiple suppliers, as does the access network for data tails in major CBD areas. But outside those areas Telecom commands the access network. The competition constraints are quite different. The high concentration of potential customers in CBDs permits the economic build of an access network by rival TSPs. Outside CBDs populations are insufficient to support more than one access network.

[40] Although the wholesale market definitions were not admitted by Telecom in its pleading, they were not challenged in argument. We note, however, Telecom's submission that the definition relied on by the Commission does not make it possible to say with respect to any tail, whether it is within a CBD area or not. Accordingly, Mr Shavin argued that it is "a wholly inappropriate foundation" for the market pleaded or for any conclusions to be reached as to dominance and market power in that market. We acknowledge that the precise geographical locations of the market boundaries are unclear, but the definition is adequate to permit a determination of the appropriate market for the vast majority of data tails in issue.

## **Dominance/market power**

[41] Although Telecom denied in its statement of claim that it had dominance or substantial market power in the wholesale markets, there was no challenge to the opinion of Professor Janusz Ordover, one of the expert economists called by the Commission, that Telecom was dominant in the wholesale market for data tails outside CBDs as well as the national wholesale market for backbone services.

[42] We agree that Telecom had substantial market power. While there are multiple providers of the core networks which comprise the national backbone, there are substantial areas of the country where only Telecom has the local access network which connects the backbone to retail customers' premises. In order to provide data services to retail customers, rival TSPs were reliant on access to Telecom's data tails.

## **Counterfactual/ECPR**

[43] As earlier discussed, the question of whether Telecom used its dominant position must be determined by considering how it would have acted if it had not been in a dominant position, but was otherwise in the same circumstances *Telecom v Clear* at 403 – see also *Carter Holt Harvey* at [29] and [52]. Telecom will not have misused its market power if the prices it charged its competitors were no greater than the prices it would have charged in the hypothetical competitive market which constitutes the counterfactual. As the Privy Council said in *Telecom v Clear* (at 403) in words which are precisely apposite in this case:

... if the terms Telecom were seeking to extract were no higher than those which a hypothetical firm would seek in a perfectly contestable market, Telecom was not using its dominant position.

[44] For the purpose of determining what those hypothetical terms might be, the Privy Council in *Telecom v Clear* endorsed the use of the economic model referred to in the judgment as the Baumol-Willig Rule, coined for the purpose of the case because it was propounded by Professors William Baumol and Robert Willig. We

will refer to it as the Efficient Component Pricing Rule (ECPR), the term by which it is more generally known.

[45] ECPR was specifically devised in order to address the problem of how to price network access in markets dominated by a single vertically integrated provider of network infrastructure and services. The seminal article on ECPR is William J. Baumol and J. Gregory Sidak, “The Pricing of Inputs Sold to Competitors”, (1994) 11 Yale Journal on Regulation 171. It identifies the objective of ECPR as to price access in a manner that compensates the incumbent for properly incurred costs, including profits foregone, while at the same time ensuring that the price of access is sufficiently low so as not to deter entry. A price set in accordance with ECPR will permit efficient entry by ensuring that an entrant’s costs will not exceed those of the incumbent. A price which exceeds it will be harmful because it impedes efficient entry.

[46] Telecom questioned whether the principles laid down in *Telecom v Clear* are applicable. Mr Shavin said that case is distinguishable because it concerned access for the purpose of providing a telephone service, a necessary element of which is ubiquity, or the capacity to provide any-to-any connectivity. Access in that case accordingly was essential to enable rivals to provide a competing service. In contrast, it was submitted, a data transmission service could be provided by a TSP acquiring an end-to-end data circuit from Telecom or building its own circuit.

[47] We are satisfied, however, that there is no reason why ECPR should not provide the appropriate model in this case. Outside major CBDs, TSPs did not have access networks and it was uneconomic for them to build networks because of the high costs in relation to available business. Access to Telecom’s data tails was essential if TSPs were to provide a competing HSDT service. While any-to-any connectivity was not required for that purpose, the potential for connection to prospective customers was required if TSPs were to offer a competing network service to a multiple-site customer. We accept Mr Farmer QC’s submission that data tails were no different in principle from local access for toll calls carried by a competing TSP lacking its own local network.

## **ECPR in this case**

[48] There are two methods by which ECPR can be applied. The first can be illustrated by reference to the end-to-end circuit illustrated in [21], adopting an example used by Professor David Gabel, one of the economists who gave evidence for the Commission. If it is assumed that:

- The prevailing retail price of data circuit AD is \$14.00;
- The direct incremental network cost of using data tails AB and CD is \$2.00 (that is, \$1 for each tail);
- The direct incremental network cost of using backbone BC is \$2.00; and
- The direct incremental retail cost of serving the customer is \$3.00;

then the cost of providing the circuit is \$7.00 and the integrated firm will earn a profit of \$7.00. Under ECPR the wholesale price to be charged to a rival for use of data tails AB and CD is \$9.00, being the direct incremental cost of the tails (\$2.00) plus the foregone profit of \$7.00.

[49] An alternative approach to the presentation of ECPR was put forward by Professors Alfred E Kahn and William E Taylor in “The Pricing of Inputs Sold to Competitors: A Comment” (1994) 11 Yale Journal on Regulation at 226. It was said to be “a more intuitively comprehensible version” of ECPR and is generally accepted to lead to the same result. The Kahn-Taylor approach may be illustrated using the same assumptions as in the previous example, namely:

- The retail price for data circuit AD is \$14.00;
- The direct incremental network cost of using backbone BC is \$2.00;
- The direct incremental retail cost of serving the customer is \$3.00.

[50] The Kahn-Taylor price for data tails is the retail price, less the costs avoided by the vertically integrated firm because another TSP is providing the retail service and backbone facilities. Those costs are \$2.00 for the backbone and \$3.00 for retail costs which, when deducted from the retail price, produce \$9.00, as in the earlier example.

[51] The Kahn-Taylor approach was used in this case, as it requires an analyst to identify only three items as against the four items required under the traditional ECPR formula.

[52] The application of ECPR in this case raised a number of issues which require resolution before we examine the calculations relied on by the parties. Two of these issues are acknowledged to be of pivotal importance:

- The implications of a TSP self-provisioning tails in a circuit.
- The correct approach when data transmission is part of a bundle of services.

### **Networks partially self-provisioned**

[53] The parties were at odds on the access price produced by ECPR when a service to a customer requires multiple tails and some of the tails are acquired from Telecom while others are self-provisioned, i.e. provided by the TSP. If the TSP self-provisioned all the tails, self-evidently Telecom would receive nothing. On the other hand, if all tails were provided by Telecom, it would receive under ECPR the opportunity cost (profit foregone) in relation to the entire network. What is the price to be charged for access under ECPR when one or more of the tails is provided by the rival TSP and the remainder by Telecom?

[54] Telecom's position is that in such circumstances it is entitled to recover the profit foregone on the entire network. Professor Gabel contended that the appropriate profit share that the incumbent should be able to recover for each tail it leases is the proportion that the leased tails bears to the total number of tails in the network. So that if Telecom provided one of five tails, it should be able to apportion 20% of the

profit foregone on the entire network to that tail. Professor Gabel's position was that if ECPR entitled Telecom to charge prices which would capture the entire profit lost on a network, a TSP would never self-provision any tails unless it was going to provision all of them. For the Commission it was submitted that this would effectively require TSPs to pay twice for the tails – once for its own investment to build them and again to compensate Telecom for its foregone profits. It is paying "coming and going" as Professor Ordover put it. Mr Farmer submitted that if ECPR entitled Telecom to price in this way, an efficient TSP could only enter if it built its own ubiquitous network.

[55] In our view, the correct application of ECPR principles is as contended by Telecom. We do not believe they would lead to the outcome postulated by the Commission. This is demonstrated by the following examples which assume a five-tail customer network, of which two tails are in a CBD and three are in a rural area. The retail price of the network is \$14 but the costs are as assumed in the discussion in [48] above viz:

- the direct incremental network cost to Telecom of each tail is \$1,
- the direct incremental network cost of the backbone is \$2 and
- the direct incremental retail cost of serving the consumer is \$3.

The cost of providing the customer network is therefore  $\$5 + \$2 + \$3 = \$10$ , so Telecom would make a profit of \$4 on this customer's business. We now examine the application of ECPR to three possible scenarios.

[56] If a rival TSP were to win this customer and seek to access all five tails then, in this simplified example, under ECPR principles Telecom could charge the TSP \$1.80 per tail – the \$1 cost per tail plus a \$4 opportunity cost spread out over the five tails. The TSP then will be paying \$9 for the tails while incurring \$5 in backbone and retail costs. It is able to charge \$14 to the customer for the network. Its profit then is zero.

[57] If, instead, the TSP wishes to self-provision a single tail in and lease only four from Telecom, Telecom could, under ECPR, charge the TSP \$2 per tail – the cost of \$1 per tail plus the same \$4 opportunity cost but now spread out over only four tails. The TSP again charges \$14 to the customer, and incurs \$5 in backbone and retail costs. After paying \$8 to Telecom, a surplus of \$1 remains. But the TSP must itself incur the cost of self-provisioning a tail. The essential point here is that it will be profitable to do so if and only if it can provide that tail more cheaply than can Telecom i.e. for less than \$1. If the cost to the entrant of providing the tail is only \$0.90, for example, then the TSP comes out 10¢ ahead.

[58] In the third scenario we assume the TSP seeks to self-provision four of the five tails at a self-provisioning cost of \$0.90 per tail. The ECPR price for the final tail will be \$5 (\$1 plus the opportunity cost of \$4) and the TSP self-provisions four tails at a total cost of \$3.60 (four at \$0.90). After the \$5 backbone and retail costs, the TSP makes 40¢ profit from the \$14 service sold to the end customer. Again this represents the efficiency advantage it has over the incumbent of 10¢ per each of four tails.

[59] These examples show that ECPR pricing does not prevent a more efficient entrant from building its own access network, as the incentive to do so is driven by any efficiency advantages an entrant may have. (In this example these pertain to the provision of tails, but advantages in backbone provision or retail costs would operate in the same way). It is true that on the assumptions we have used the TSP will always self-provision its entire network: if it makes a profit on each tail it self-provisions then it will wish to self-provision the lot. A more realistic example, however, might have differential costs per tail for the TSP: \$0.90 for each of the two CBD tails, say, but \$3 for each of the three rural tails. In such a case the TSP might self-provision the two CBD tails but not the others, but still be profitable under ECPR pricing of the leased tails<sup>2</sup>. This example also makes it clear why violations of ECPR pricing by the incumbent will deter efficient entry. If Telecom in this

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<sup>2</sup> For completeness, in this case the ECPR price for each of the three tails would be \$1+\$1.33, or \$2.33 each, for a cost to the TSP of \$7 in payments to Telecom. On top of this the TSP incurs \$1.80 for the costs of self-provision and \$5 in other direct costs and so makes 20c profit, as expected. If it tried to self-provision a further tail, the total payment to Telecom would fall by \$1 and its own costs would rise by \$3. This would obviously not be profitable.

example were to charge \$3 for each tail then the TSP would make losses leasing the two rural tails. It would incur total costs of \$15.80 (\$9 in lease costs plus \$5 in backbone and retail costs plus \$1.80 in self-provisioning costs) to provide a service for which it can charge only \$14.

[60] We conclude that under ECPR pricing an incumbent is entitled to recover from a rival the full opportunity cost of providing network access. Pricing of data tails on this basis will not preclude entry by a more efficient rival.

*Entrant's sunk costs*

[61] An associated issue arising from ECPR pricing identified by Professor Gabel is the effect of sunk or fixed costs associated with self-provisioning a tail. These are the initial startup costs which are independent of the volume of output. They are in two categories: fixed costs which can be recouped if the firm subsequently exits the industry, and sunk costs which cannot be recouped. Professor Gabel maintained that sunk costs of entry may preclude efficient entry. Professor Hausman agreed that ECPR does not lead to efficient entry when there are sunk costs, though, according to Professor Ordover (who agreed with Professor Gabel), Professor Hausman was talking about the incumbent's fixed costs. Their concern is that the incentive to build access will be removed if, in addition to compensating the incumbent for profits foregone on an entire customer network, an entrant also incurs sunk or fixed costs in self-provisioning a tail. For the Commission it was argued that this outcome is "irremediably inconsistent" with the judgment of the Privy Council in *Telecom v Clear*.

[62] We do not accept that ECPR leads to an inefficient outcome by virtue of the sunk costs of new entrants. The reasons are given by Kahn and Taylor in "The Pricing of Inputs Sold to Competitors: A Comment" (cited above at [49]) at 237 - 8.

When a would-be entrant proposes to offer its services in competition with an existing supplier, it is the task of efficient competition to ensure that the aspiring competitor prevails to the extent – and only to the extent – that the total incremental costs to society involved in its supplying the service are equal to or lower than those of the incumbent.

...

If the incumbent telephone companies could profitably retain the competitive business at prices covering only their marginal costs but the challengers require some larger markup, in order to recover for themselves some of their fixed, common costs, then it is inefficient for society to make it possible for the latter to do so; it would involve the wasteful duplication and incurrence of new, additional common costs of facilities and activities already provided by the incumbent.

[63] We find this reasoning compelling and accept also that the inclusion of Telecom's foregone profits as well as sunk costs is not inconsistent with *Telecom v Clear*. The Privy Council endorsed ECPR as a model which would provide the efficiency outcomes for society, which is the goal of the Commerce Act. ECPR alone may not encourage efficient entry but it will certainly discourage inefficient entry. As Baumol, Ordover and Willig write:

The discussion that follows will show that a bottleneck-input service sold by its owners to competitors in the supply of final product must be priced in accord with ECPR if inefficiency in resource allocation is to be prevented. The recent critics have argued, correctly, that the rule, by itself, is certainly not sufficient to ensure efficiency, a reservation we have been at pains to emphasize since two of the authors of this Article first enunciated the rule some years ago." (W Baumol, J Ordover and R Willig, "Parity pricing and its critics: a necessary condition for efficiency in the provision of bottleneck service to competitors" (1997) 14 Yale Journal on Regulations 145 at 147.)

## Bundled services

[64] The second issue of critical importance to the application of ECPR in this case concerns the approach to be taken when data transmission is part of a bundle of services. Telecom argued that when data services are supplied to a customer as part of a "bundle" – including voice and/or internet services – the profits lost on all services, not just the data service component, should be taken into account in calculating the ECPR price.

[65] This contention, when it was explicitly raised, took the Commission by surprise and Mr Farmer submitted that Telecom should not be permitted to raise the issue. He said the Commission had been prejudiced both in respect of the scope of discovery and the evidence which it had prepared and led. It had no opportunity to brief Professors Ordover and Gabel before they gave oral evidence.

[66] In response, Mr Shavin pointed to evidence in the briefs of three witnesses which suggested that the supply of voice and internet services was frequently important to the supply of data services. He pointed out that there was some exploration of the issue in cross-examination.

[67] We are satisfied that the Commission was not given proper notice that the issue would be raised. There was no pleading of a market for bundled services; the product market was admitted to be high-speed data transmission services. The references in the briefs of evidence were insufficient to amount to notice that the issue would become a major plank in Telecom's defence. Undoubtedly the Commission was prejudiced as a result. The scope of discovery and evidence of fact would have been affected. The opportunity to brief experts before the hot tub was lost. As it happens, however, no great harm resulted. Professor Ordover's ability to address the issue was not fatally compromised and it is desirable that we state why we agree with his view.

[68] There was evidence that some TSPs sold voice and data services as a bundle and that sales of data services sometimes were made as an entrée into the sale of voice services. In arguing that in such cases the appropriate measure of opportunity cost is the sum of foregone profits in respect of all services, Professor Hausman relied on a 1996 paper by M Armstrong, C Doyle and J Vickers "The Access Pricing Problem: A Synthesis" (1996) 44 Journal of Industrial Economics 131.

[69] This paper presents a general analysis of access pricing in a model that allows for the presence of multiple goods produced downstream with the use of multiple upstream 'bottleneck' inputs. The authors also allow for the possibility of bypass in this analysis – the ability of an entrant to reduce their dependence on the bottleneck inputs provided by the incumbent – as well as imperfect substitutability between the

downstream goods provided by an entrant and an incumbent. Both of these effects reduce the opportunity cost to the incumbent of providing access to its inputs and are termed ‘displacement’ by the authors. The authors derive an expression for the appropriate ECPR price of one of these bottleneck inputs and show that it is comprised of four separately identifiable components, two of which are relevant to the situation before us. The first of these is a term representing the marginal cost to the incumbent of providing access to the input for the entrant, a component of ECPR pricing as discussed above. The second is a term that captures the opportunity cost to the incumbent of providing that access. In the case of a single input and multiple outputs, this term boils down to an expression, modified by the displacement ratio, that sums the lost profit of the incumbent across all of its downstream markets.

[70] We agree with Professor Ordover that the analysis in the Armstrong et al paper does not apply to the facts we are considering. Armstrong et al consider only a situation where inputs are essential for the production of the outputs in question. That is not the case here. While it might be helpful to a TSP to have a customer’s data business in order to offer them a voice service, it is not essential. The ability to make data sales is not essential to the sale of voice or internet services. Telecom could lose a data customer but would still be able to compete for voice business. Were Telecom to be compensated for the loss of profits on other lines of business when it loses data service to a customer, it would be discouraged from competing for the remaining services.

[71] What is foregone by the incumbent when it loses a data service customer is the ability to offer a bundle of services, not the ability to offer other components of the service such as voice or internet. If the incumbent is to be compensated in an ECPR price for losing a data service customer, it is only to the extent of the additional profit derived from supplying the services as a bundle. However, neither party attempted to quantify the additional value placed by customers on having downstream services bundled. We doubt that it would be significant. Bundling was by no means ubiquitous in the retail markets; there is no evidence that it was so highly valued that every consumer pursued it, and Telecom seems not to have raised concerns in its internal discussions of wholesale pricing about the possible impact on other bundled services.

[72] We are satisfied that there is no risk that ECPR prices calculated by the Commission are materially understated on this account.

## **Other matters**

[73] It is convenient at this point to consider three further matters which have a bearing on ECPR pricing.

### *Value of real option*

[74] For Telecom Professor Hausman argued that ECPR pricing should include an option fee, which compensates Telecom for the opportunity it confers on an entrant to defer a decision to build out its own access network. Because a decision to build out a data tail involves a commitment to (irrecoverable) sunk costs and the risk of losing the customer – customer “churn” – there is a value to the TSP in deferring its decision to invest until some of the uncertainties are resolved. The ability to delay the decision will be valuable if it enables a firm to learn more accurately the pros and cons of an investment which, when made, would leave Telecom with “stranded assets”.

[75] There was no attempt to quantify the value of the option or, indeed, to establish by empirical evidence that it has any value at all. Our assessment is that any value which might be attributed to the option would be insignificant. There is merit in the Commission’s submission that, if the issue is of real concern for an incumbent, it would be addressed contractually, for example, by giving incentives to TSPs to sign long-term contracts for data tail leases.

### *New customers*

[76] The Commission argued that if a sale of data services by a TSP is made to a new customer, the appropriate ECPR price will be lower than otherwise. This is because the opportunity cost to Telecom of giving up the tail is very low and may even be negative if the TSP’s activity results in the increased possibility of customer

churn. We accept that this is a potentially significant factor; Telecom itself acknowledged that the presence of rival TSPs was of value to Telecom to the extent that they would grow the market for everybody.

[77] The issue was addressed empirically only insofar as analysts on both sides considered the avoided costs to Telecom arising out of savings on the backbone: the decreased traffic would enable Telecom to defer expansion of its backbone network. However, in the absence of evidence as to the overall growth of the data services market, we are unable to assess the impact of new customers on ECPR prices.

#### *VBR v CBR*

[78] As earlier discussed ([15]-[16] above), data could be transmitted by a CBR (constant bit rate) or VBR (variable bit rate) service. Initially Telecom offered rival TSPs only CBR tails. It was not until October 2000 that VBR data tails were first offered by Telecom to Clear, and not to other TSPs until much later. As we understand it, at no stage did TSPs acquire VBR tails.

[79] While using CBR tails, TSPs however generally offered a VBR service to customers. As a non-dedicated service, VBR was cheaper and enabled TSPs to utilise their backbone networks to achieve a competitive advantage. However, TSPs required CBR inputs so they would not be constrained by the performance characteristics of Telecom's VBR service. Unless Telecom provided a CBR tail, a TSP could not offer a CIR (committed information rate), either because Telecom's VBR tail provided a lower CIR or because the average speed delivered by the TSP could be reduced by congestion on Telecom's network. If Telecom provided a CBR tail, a TSP could offer either a CBR service or a VBR service at a speed which would depend entirely on the congestion in the TSP's own backbone. On the Commission's case it was essential that Telecom provide CBR tails to rival TSPs as the speed of service was an important dimension on which they competed. (We will consider later Telecom's argument that it would have been technically possible for it to provision VBR tails that still enabled a TSP to provide a VBR end-to-end service configured to the TSP's requirements.)

[80] Telecom contended that, because the CBR input could be used by TSPs to provide a higher priced CBR service, the appropriate retail price for the Kahn-Taylor calculation of ECPR should be derived from the retail price of a CBR service. The Commission argued the appropriate retail price was of the VBR service actually provided. Telecom countered that the lower price of a CBR input which resulted from using the VBR retail price would provide TSPs with an artificial price advantage – an arbitrage opportunity – in providing CBR services.

[81] In support of this contention, Dr William Taylor, one of the economists called by Telecom, employed the analogy of the Butcher's Tale. He postulated the case of a butcher who sells mince steak at \$4/kilo and steak at \$10/kilo. He said the butcher should not be required to provide steak to rivals at a wholesale price that enables them to sell it, profitably, as mince at \$4/kilo, because they could then turn around and sell it directly as steak.

[82] We agree with Professor Ordover that there are “problematic economics” in the analogy. If the butcher earned more in selling a kilo of steak than a kilo of mince, he would sell more steak and less mince, driving the price of steak down and the price of mince up until the per-unit profit is the same. At this point the “multiple ECPR” problem disappears; both outputs would have the same per-unit profit (opportunity cost) and thus the same ECPR price.

[83] We do not overlook Professor Hausmann’s argument which, as we understand it, is that if an incumbent firm must charge the same price for all data tails it sells, regardless of whether they are used in CBR or VBR end-to-end circuits, then it will no longer be able to “price discriminate” in the downstream market into which these tails are input – i.e. in the consumer market for end-to-end data circuits - and might even then choose to offer no data tails at all. The concern is that TSPs having constant-price access to inputs to different downstream services will arbitrage away any downstream price difference for, say, VBR and CBR services, forcing all firms to price both products identically. Consumers would suffer and the incumbent might then not offer tails at all if required to offer them at the same price regardless of downstream use.

[84] In our view, any loss of the ability to price different downstream products differently (even assuming such a loss would occur) is irrelevant to the central issue we are required to address – whether there has been a breach of s 36. As Professor Ordover pointed out, the issue is whether a non-dominant firm would supply tails to a rival in the counterfactual and the downstream pricing consequences of that are immaterial. Further, as Telecom's pricing structures have not changed since the introduction of unbundled partial circuits (UPC) in 2004, it would appear that making wholesale data tails available on terms which do not violate s 36 did not, in fact, eliminate any ability of Telecom to price discriminate downstream.

[85] We conclude that the appropriate basis on which to determine ECPR prices is the retail price of a VBR service actually provided, notwithstanding that it utilised CBR inputs.

### **ECPR pricing analysis**

[86] Professor Gabel developed a model for the purpose of determining whether the wholesale prices charged by Telecom for data tails over the relevant period violated ECPR. He considered a two-tail configuration in which Telecom supplied both tails. He applied his model to 1999, 2002 and 2004. He examined four scenarios in each year. The scenarios differed according to the technology employed in providing the access and whether the tails were CBR or VBR. They also varied depending on whether the tail involved a local or national step. A step is the length of the circuit ABX or DCY (in the diagram at [21]). A shorter or local step (one which begins and ends in the same city) is priced lower than a longer or national step.

[87] For Telecom, the analysis was carried out by Mr Iain Fraser, an economist employed by Telecom. In addition to the two-tail circuit examined by Professor Gabel, he analysed a one-tail case, where the TSP leases one tail to Telecom and self-provides the other in a two-tail circuit. In the course of the hearing Professor Gabel responded with his analysis of a one-tail case and both experts analysed a configuration in which a TSP self-provided one of three tails in a circuit. Mr Fraser

also provided calculations for a more complicated setting in which a TSP leased ten tails in a twenty-tail circuit. We did not find this scenario particularly helpful.

[88] Professor Gabel found evidence of ECPR violations in every permutation in the first three scenarios of the two-tail case but in the fourth scenario only when the entire AD link is local or when one or both of the ABX and DCY links are national. Mr Fraser generally endorsed these results for the two-tail case.

[89] For the one-tail analyses, Professor Gabel found broadly that ECPR violations will not occur when the leased tail involves a local pricing step but will occur if it is priced as a national step. Mr Fraser found no ECPR violations and, in a sensitivity analysis, found that Professor Gabel's conclusions are overturned if any of the following variations are introduced:

- Consistent VBR/VBR or CBR/CBR circuits are used;
- The transport price for the leased tail is "local";
- The "retail costs saved" are 6.32% of retail revenue;
- Telecom's numbers for "access costs saved" are used in 1999.

[90] For the multi-tail analysis, Professor Gabel found an ECPR violation in his three-tail example where the TSP self-provisions a single tail. Mr Fraser disagreed and found no ECPR violations in his 20-tail example under either Professor Gabel's or his own cost and price assumptions. He showed that Professor Gabel's finding depended on an assumption of national pricing. He also claimed that there would be no violation if VBR pricing was assumed for both wholesale and retail prices.

[91] The following additional points of difference may also affect the analysis:

- The allowance for marketing costs.
- Quasi-fixed costs.
- The proportion of self-provisioned tails.
- The end use of a CBR tail.
- Access costs.

- Retail price for 64 kbps services.
- ATM utilisation rates.

We examine each in turn.

#### *Marketing costs*

[92] Among the costs Telecom avoids if it supplies a tail to a rival is the cost of marketing its retail service to customers. The experts disagreed on the appropriate measure of this. Professor Gabel used a figure of 16% for his one-tail analyses and 8.32% in his two-tail analyses. The 16% was the value adopted by the Commerce Commission in Decision 497 and has been used by state regulatory agencies in the United States. Mr Fraser used 8.32% adjusted downwards by 2% to allow for the extra marketing costs he suggested Telecom would incur at the wholesale level as a result of selling the tail wholesale to a TSP rather than retailing to an end consumer.

[93] There is agreement that avoided retail costs should be net after allowing for wholesale costs. However, the experts disagreed on:

- Whether the figure of 8.32% used by Professor Gabel had already allowed for the additional marketing costs incurred at the wholesale level.
- If not, whether an adjustment of 2% is correct.

[94] The 8.32% was Telecom's own calculation, initially based on calculations by Bruce Parkes of Telecom. Mr Fraser said that Mr Parkes' figures did not appear to incorporate wholesaling costs. However, in the absence of evidence that wholesaling costs were omitted, we see no reason to accept that they were.

[95] If, contrary to this assumption, added wholesale costs were not deducted, we would have been inclined to accept the 2% adjustment proposed by Mr Fraser based on 2008 costs, while noting Professor Gabel's concern that the resultant figure would be much less than the 16% adopted by the Commerce Commission and in other jurisdictions.

[96] An associated point concerns what are termed customer care costs. These are costs associated with such activities as retail and retail inquiry. It is agreed that they are avoidable costs, but again there is disagreement whether they are included in Telecom's calculations from which the 8.32% was derived. Professor Gabel surmised that they were excluded as they are not mentioned. Telecom's experts took the contrary view. In the absence of evidence that customer care costs were excluded when sales and marketing costs were calculated, we assume that they have been included and would make no further allowance on that account.

[97] In closing, Mr Farmer submitted that a figure for avoided marketing costs much closer to 16% would be justified on Telecom's figures, particularly for later periods. He pointed out that Mr Fraser's calculation of 8.32% was based on prices and costs in 1999. As retail prices fell dramatically in later years while costs are presumed to have remained constant, the percentage which costs bore to retail prices would have risen dramatically. There is obvious force in this submission. It indicates that 8.32% is conservative, but there is no empirical evidence which would permit us to adopt a higher figure.

#### *Quasi-fixed costs*

[98] A further issue in relation to avoided costs, is whether what may be termed quasi-fixed costs should be included. These are costs which vary with output but in a discontinuous fashion. Professor Gabel cited as examples the cost of support provided to customer services personnel by human resources, information management and general administration. He pointed out that Telecom's costing models included such costs and that international experience (particularly determinations of US state and federal regulators) allow for such costs in determining avoided costs in this setting.

[99] In our view, the question of whether or not to take quasi-fixed costs into account will depend on the effect the provisioning of tails to rivals has on Telecom's retail sales. If only a single tail is involved, the appropriate costs would not include any allocation for quasi-fixed costs whereas, if an access seeker is seeking a large number of tails, it would be reasonable to include such avoided costs. Again, there is

insufficient data to enable us to quantify such costs, but it reinforces the conclusion that the 8.32% estimate is conservative, particularly where multiple tails are leased.

*Proportion of tails self-provisioned*

[100] We have concluded that the appropriate ECPR price will depend on whether any tails in a circuit have been self-provisioned by the TSP. However, there was no direct evidence as to the number of circuits falling into this category.

[101] The issue arises only in relation to tails leased by TelstraClear; no other TSPs had access networks at the time so all tails would have been provisioned by Telecom. Dr Taylor suggested that the number of circuits in which TelstraClear self-provisioned a tail could be extrapolated from the proportion of TelstraClear's aggregate tails leased from Telecom. Based on evidence that Clear leased [ ]% of its total tail use from Telecom in 1999, Professor Gabel calculated that the share of TelstraClear's circuits in which both tails were leased from Telecom would be [ ]%.

[102] In our view, this methodology is potentially misleading, as it assumes that a circuit with one end outside a CBD is just as likely to have the other end outside a CBD as it is to have it inside. But, as all of TelstraClear's self-provisioned tails are in the major CBDs, it is more likely that a circuit with one end outside a CBD will have the other end inside a CBD – and therefore be self-provisioned – than to have it also outside a CBD. This would suggest that Dr Taylor's methodology applied in the way proposed by Professor Gabel would overstate the proportion of tails that belonged to circuits in which both tails were leased.

[103] The proportion will be further reduced when it is considered that TSPs used Telecom tails in order to serve multiple connections outside CBDs. It seems likely that most customers would seek connections of more than two end points.

[104] We think it is safe to conclude that over the period, TelstraClear would have self-provided at least one tail in most of the circuits in which it leased tails from Telecom. However, there was no evidence of the configuration and distribution of

circuits operated by TelstraClear. As we will later discuss, this presents difficulties in quantifying the extent of ECPR violations.

*The end use of CBR tails*

[105] Professor Gabel priced many of his ECPR simulations on the basis that a CBR tail was provided for use in a VBR end-to-end service. Mr Fraser suggested that his use of the retail price of a VBR end-to-end service to determine the ECPR price explained many of the ECPR violations that Professor Gabel found to have occurred.

[106] We do not think Professor Gabel erred on this issue. The ECPR price is derived from the retail price of the downstream service that the incumbent (Telecom) is actually selling (in order to calculate its actual opportunity cost). The relevant comparison then is with the actual wholesale price charged by Telecom for access to the input in question. In this case, the input sought was always a CBR tail; Professor Gabel was right to use CBR for the wholesale price. However, for the purpose of determining the appropriate ECPR price, it is the actual use to which the tail was put that is relevant. A CBR tail could be used to provision a CBR end-to-end service but we think it more likely that it would have been used for a VBR service. That is because we were given no reason to think that a customer, when switching to another TSP from Telecom, would change the nature of its end-to-end service. Accordingly, the provision by the TSP of a VBR circuit suggests that is likely to have been the service previously provided by Telecom. For these reasons, we conclude that Professor Gabel was right to adopt as the appropriate circuit configuration a CBR tail being used for a VBR service.

[107] In closing submissions we encountered competing submissions as to the technical ability of Telecom to actually provide VBR tails to rival TSPs before the significant rollout of DSL (Digital Subscriber Line) technology in 1997. Telecom contended that it was feasible from the time of its FR rollout in 1994, had TSPs sought it. Telecom referred to offers it made to other carriers in March 1999 explicitly listing VBR tail options. For the Commission, it was submitted that these were offers to TSPs of end-to-end VBR services for resale only and do not indicate

the availability of tails. The Commission further submitted that even if VBR tails were made available, they could not be used by TSPs without the stacked wideband access (SWA) service which was available only with CBR or DDS circuits.

[108] We are unable to resolve this conflict as the witnesses on both sides who were in a position to answer the question were not asked. However, the point may be of little consequence. It is common ground that VBR tails were available – at least to Clear and Telstra – in 2000 and 2001 respectively. In 2001 Telecom also upgraded its DSL equipment so as to permit VBR tails to be provisioned through high-speed symmetric ATM connections.

[109] It is also relevant that, as earlier noted, the availability of VBR tails in 1999 would not have assisted TSPs, as they could not have used them to provide a service that could be differentiated from Telecom's. Mr Muneeb Bhatti, an electrical engineer who held managerial posts in Clear between 1995 and 2005, said that for Clear to provide its own VBR service would be very difficult technically and would have "created absolute havoc". The Commission submitted that, even if it was technologically possible to provide a VBR service, it would have been impractical to have negotiated traffic contracts with Telecom to customise VBR tails in a way that rendered them useful. Telecom maintained that a contractual solution was available but we are not persuaded this would have been achievable in practice.

[110] Our conclusion is that VBRs were made available to TSPs, from at least 2002 onwards, earlier in some cases. However, we accept that the likely costs of having them configured in a way that would enable the TSP to control the specifications of its end-to-end service were so high that only by the use of CBR tail circuits could a TSP differentiate its retail offerings from those of Telecom.

#### *Access costs*

[111] For the purpose of calculating ECPR prices, there are three points of difference as to the access costs saved when a TSP self-provisions a tail. The first is the cost of redeploying a customer's NTU at another's site. Because NTUs could be

reused, Mr Fraser considered their costs avoidable but decreased that cost by 10% to take account of pickup costs. Professor Gabel made no allowance for this.

[112] On the other hand, Professor Gabel, in using Telecom's own costs model, implicitly took into account an allowance for bearer costs on the assumption that the copper pairs of the now-redundant Telecom tail are reused. He also made allowance for the avoided costs of providing the backbone.

[113] There is no apparent reason why costs should not be reduced on the basis proposed by Mr Fraser to allow for reuse of NTUs. Against this, we consider there should be an allowance to take account of the network costs saved on the local copper loop. We exclude as insignificant avoided costs on the backbone.

[114] Because the savings in network costs were not quantified in evidence, we can conclude only that Mr Fraser has under-estimated saved access costs. We cannot say by how much.

#### *Retail price for 64 kbps services*

[115] The price of Telecom's 64 kbps service was not included in its Streamline pricing. Professor Gabel used the price in Telecom's List of Charges (TLoC) less 65%. Mr Fraser preferred a discount of 30%.

[116] Professor Gabel relied on an undated document prepared by Telecom for the Commerce Commission listing discounts as at June 2000. They disclosed an average discount off TLoC of 68%. However, the pricing is post-Streamline; it is a mixture of DDS and FR services and does not specify bandwidths of the provided circuits. We do not find it a reliable basis for determining the appropriate discount. Another document, prepared by the Commerce Commission from information disclosed by Telecom, suggested the most common Telecom retail discount in March 1999 was 30%, rising to 70% in June 1999. Again, however, the data is not disaggregated by bandwidth.

[117] Mr Fraser relied on a report prepared by a management team within Telecom, undated but identified in evidence as having been prepared in August 1998, which states at 2.3:

Discounts of 30-50% off TLOC are now the norm in corporate sales, with the special deals process routinely invoked, particularly in the switched data services like FRS. Discounts below TLOC range from premier plan to special rates of up to 55% discount off TLOC. With such a wide range of prices in the market from Telecom alone, it follows that there is no “market price” as such for our data services.

...

Competitive offers tend to be based on “whatever you’re currently paying Telecom less 30%”. This stimulates a focus on price rather than on value add or growth. Our most common response to this is therefore to promptly drop our prices to match.

[118] Mr Fraser’s implicit assumption is that the reference to “whatever you’re currently paying Telecom” is to TLoC prices. However, it is clear that TSPs were paying Telecom significantly less than TLoC. The report says nothing about Telecom’s actual price to TSPs.

[119] The document we found to be of most assistance was prepared by Telecom and lists 92 examples of what are referred to as “special deals”. In cross-examination Professor Gabel roughly calculated an average discount of around 50% for those relating to 64 kbps service. Our own calculation is that the average discount is 43%. Although derived from a limited sample, we find this a more reliable estimate than those adopted by Professor Gabel and Mr Fraser.

#### *ATM utilisation rates*

[120] Finally, Professor Gabel and Mr Fraser differed on the approach to pricing of ATM (Asynchronous Transfer Mode) access. Although their differences were not material for the purpose of this case, it may be helpful if we express our view.

[121] The issue concerns the charges that a TSP faced when it leased an ATM port from Telecom and so relates to the calculation of actual wholesale prices to be compared to ECPR prices. ATM is a high performance switching and multiplexing

technology that can carry a range of services including voice and video as well as data. The price was a fixed amount regardless of use by the TSP. We were told that TelstraClear could only utilise, on average, [ ]% of the typical ATM pipe bandwidth. The question is how the per-ATM port price should be calculated per circuit going into it. The actual per circuit costs faced by an entrant using only part of the band width would be much higher than the costs faced by an entrant using the entire bandwidth. Which is to be adopted?

[122] In our opinion, the appropriate basis should be that of an hypothetical efficient entrant. This does not necessarily mean 100% utilisation. It may be, for example, 67%, which was the rate at which Telecom utilised its own equipment. However, the price should be based on the utilisation of an efficient entrant, as the TSP is in a position to choose its level of utilisation. If a TSP were able to use its own utilisation rate in determining the apportionment of costs per circuit, it would be to invite gaming of the price and to “reward” an inefficient entrant.

## Evaluation

[123] It is convenient to summarise at this point our findings on the different approaches to calculating ECPR violations. We have concluded that in calculating ECPR prices:

- When a TSP self-provisions a tail or tails in a circuit and Telecom provisions the remainder, Telecom is entitled to recover the opportunity cost (profit forgone) in relation to the entire network.
- The existence of sunk costs for an entrant does not invalidate their use as a model for determining efficient outcomes.
- Telecom is entitled to recover the additional profit derived from the supply of a bundle of services only to the extent discussed in [71] above. However, this may be disregarded for the purpose of calculating the ECPR price in this case as the Commission was not given proper notice that the issues would be raised and the amount involved would, in any event, not be material.

- There is no justification for including the value of an option fee.
- There is insufficient data to permit allowance to be made for the effect of a sale by a TSP to a new customer.
- The price of a VBR service should be based on VBR prices even though CBR tails were used to provide the service.
- Avoided marketing costs based on 8.32% of retail price are conservative but there is no evidence which would permit the adoption of a higher figure.
- There is insufficient evidence to warrant making an allowance for quasi-fixed costs.
- Telecom's calculation made insufficient allowance for saved access costs.
- In calculating ECPR violations the retail price of Telecom's 64 kbps service should be TLoC less 43%.

[124] These findings do not affect Professor Gabel's conclusion (largely accepted by Mr Fraser) that, except in one scenario, there were ECPR violations throughout the period when Telecom supplied both tails in a two-tail circuit. This is confirmed by evidence that Telecom's wholesale price to TSPs for an end-to-end data service consistently exceeded its retail prices.

### **Use of dominance**

[125] The issue we now consider is whether, in pricing above ECPR in the two-tail scenario, Telecom used its dominant position. That requires a consideration of whether a non-dominant firm, otherwise in the same position as Telecom, would have offered data tails to rivals at above ECPR prices.

[126] The Commission invited us to analyse the issue in two steps. The first is to enquire whether there was an obligation to supply data tails at all. The second is

whether supply in the counterfactual by a non-dominant incumbent would be at prices in excess of ECPR.

[127] Telecom was not under an express statutory obligation to supply data tails. There was agreement that the “essential facilities” doctrine has no application save to provide “valuable insights” to the operation of s 36 – *Union Shipping NZ Limited v Port Nelson Limited* [1990] 2 NZLR 662 at 704 – 706<sup>3</sup>. Rather, the Commission relied on the existence of a duty on a vertically integrated incumbent to supply an essential wholesale input to a competitor in a downstream market as found in *Queensland Wire Industries Pty Limited v Broken Hill Pty Co Limited* (1989) 167 CLR 177 (HCA). Such an obligation was apparently assumed to exist in *Telecom v Clear*.

[128] As earlier noted, Telecom’s position is that *Telecom v Clear* is distinguishable. However, we are satisfied, for the reasons earlier discussed (at [46] – [47]), that there is no material distinction between the pricing for interconnection at issue in that case and the pricing of data tails. As we see it, data tails are an essential input into an HSDT; Telecom was in a position to supply the data tails; and a refusal to supply at prices which did not exceed ECPR could breach s 36.

[129] We are also satisfied that in the agreed counterfactual comprising two vertically integrated firms, each with a 50% share of the high speed data transmission business, a non-dominant Telecom would not set prices for data tails at above ECPR. As Professor Ordover said, that is so for the simple reason that if it did so the backbone provider would purchase input from another company and Telecom would lose the sale entirely. We accept his evidence that in a competitive market Telecom would eventually have been forced to supply at prices below ECPR and approaching marginal cost. As Mr Farmer submitted, this is consistent with what was envisaged by the Privy Council in *Telecom v Clear*, which referred to the process by which Telecom’s prices to Clear would be forced down until any element of monopoly profit “is competed out” – at 397.

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<sup>3</sup> The same can be said of the American price squeeze cases referred to by Telecom, notably *Verizon Communications Inc v Law Offices of Curtis v Trinko LLP* 540 US 398 (2004) and *LinkLine Communications Inc v SBC California Inc* 530 F 3d 876 CLR (9<sup>th</sup> Circuit, 2007)

[130] Mr Shavin submitted that proof of violations in the two-tail scenario was, nevertheless, insufficient to establish use of a dominant position. He argued that the Commission's failure to provide evidence of the number and distribution of two-tail circuits constituted an immovable obstacle to establishing a breach of s 36. He said that when, as in this case, there are a large number of ECPR prices, the effect of non-compliance on the market can be measured only if the full extent and incidence of violations (and compliance) is known. He said incidents of violation in the two-tail scenario cannot be viewed in isolation to exclude Telecom from the "safe harbour" provided by ECPR: rather, whether Telecom is in breach or otherwise must be determined from the aggregate of ECPR calculations over the variety of data transmission service offerings in the market.

[131] In our view, the absence of information about the magnitude and distribution of ECPR violations is not fatal to the Commission's case. We accept Mr Farmer's submission that as long as non-compliance is more than *de minimis* it may found a breach of s 36. The number and extent of breaches goes to the gravity of the breach, not to its existence.

[132] We know that violations of ECPR occurred in virtually every scenario in the two-tail case. We do not know the extent to which this affected supply to TelstraClear; there is no reliable data that would enable us to quantify the numbers of two-tail circuits TelstraClear acquired. But we know that there was frequent supply of two-tail circuits to other TSPs (who had no circuits of their own) often at prices that exceeded Telecom's price to retail customers for the equivalent end-to-end circuits. This arose because Telecom's pricing involved treating a TSP as if it were in effect obtaining two end-to-end services with charges for access and transmission doubled. In one example referred to in evidence, a TSP acquiring two data tails would have been required to pay Telecom \$916; that is \$176 more than Telecom's retail price of \$740 for the end-to-end service.

[133] Pricing at above ECPR will have had the effect of discouraging efficient competition for backbone services and in the retail data services market. Rivals would have higher costs than Telecom. Potential entrants would be discouraged or

would enter on a smaller scale. These outcomes can be expected, though on a reduced scale, when violations are confined to the supply of two-tail circuits.

[134] The Commission relied on anecdotal evidence of Telecom's rivals as consistent with economic theory. It included evidence that:

- One TSP, Attica Communications Limited, a telecommunications company whose services included data transmission, was forced out of business by Telecom's pricing policies. Its founder, Wayne Toddun, referred to Telecom charging for access circuits at prices significantly higher – more than double in one case – than Telecom's prices for its own customers.
- Clear claims that it lost between \$[ ] and \$[ ] as a result of Telecom's pricing strategy. This estimate was made in 2000 and included loss of market share and losses incurred in retaining business.
- TSPs were able to remain in the market only by introducing value-added products and other services and selling products that subsidised their losses on data services.

[135] We make no findings that these outcomes flowed directly from Telecom's pricing policies. We acknowledge that a multitude of factors are likely to have contributed in each case. They are, however, consequences of the kind that economic theory would predict when prices exceed ECPR and, in some cases, the retail prices being charged by Telecom. Other consequences - the discouragement of potential entrants for example - are by their very nature unobservable. There is nothing, however, in the empirical evidence that is inconsistent with a finding that in pricing above ECPR Telecom used its dominant position.

### **Purpose**

[136] The Commission's case is that Telecom used its dominant position for the purpose referred to in s 36(2)(b) of the Act (s 36(1)(b) of the Act pre-2001), namely:

- Preventing or deterring existing or potential TSPs seeking access to Telecom's data tails (and using their own backbone infrastructure) from competing in the retail market; and
- Deterring existing or potential TSPs from competing in the national wholesale market for backbone transmission services.

[137] Purpose may be inferred from the effects of use of a dominant position. The Privy Council said in *Telecom v Clear* at 402:

If a person has used his dominant position it is hard to imagine a case in which he would have done so otherwise than for the purpose of producing an anti-competitive effect; there will be no need to use the dominant position in the process of ordinary competition. Therefore, it will frequently be legitimate for a Court to infer from the defendant's use of his dominant position that his purpose was to produce the effect in fact produced. Therefore, as the Court of Appeal in the present case accepted, use and purpose, though separate requirements, will not be easily separated: see *Electricity Corporation Ltd v Geotherm Energy Ltd* [1992] 2 NZLR 641; *Union Shipping NZ Ltd v Port Nelson Ltd* [1990] 2 NZLR 662.

See also *Carter Holt Harvey v Commerce Commission* at [40].

[138] Purpose may also be established by direct evidence, including evidence that an anti-competitive outcome was a substantial purpose of Telecom's conduct – s 2(5)(b) of the Act.

[139] The matters relied on by the Commission as providing direct evidence of an anti-competitive purpose are:

- Telecom's delay in introducing CDP.
- Telecom's “network of choice” strategy.
- Acknowledgements by Telecom that its philosophy was that there should be no price competition between Telecom and rival TSPs.
- The absence of evidence from those responsible of the purpose of CDP.

### *Delay*

[140] Streamline retail pricing came into effect on 1 February 1999. It was rolled out quickly and, we accept, covertly. Murray Goodman, then Business Development Manager of Telecom, who had direct responsibility for the development of Streamline pricing, agreed that the secrecy surrounding the introduction of Streamline enabled Telecom to sign up customers before competitors knew what was happening.

[141] While indicative revised wholesale prices were released to TSPs in late February 1999, an approved pricing offer, which became CDP, was not made until 31 March. It was not revised and completed until August 1999. Stuart Goodin, who was then Telecom's Strategy and Pricing Manager and who was given responsibility to review data pricing to TSPs, accepted that the delay in introducing CDP would have disadvantaged rival TSPs.

[142] The implications of the mismatch between the introduction of Streamline and of CDP were magnified because of the significance of term contracts in data transmission. One of the business rules of Streamline sales was that the customer had to sign up for a term of a year or more and we were told that the modal contract was around a year. While TSPs would have been handicapped in their ability to compete in the short term, in the longer term the effects of the delay would have dissipated. However, the way in which the new pricing regime was introduced, suggests that Telecom sought to exploit the opportunity to secure an advantage over rival TSPs.

### *Network of choice*

[143] In developing Streamline pricing and CDP, one of Telecom's acknowledged objectives was to incentivise TSPs to view Telecom as the “network of choice”. Its goal was to encourage rivals to use Telecom's access network rather than build their own. The Commission argued that the reason for Telecom's strategy was to prevent rivals from being “true competitors”, who would compete on price as well as service. Telecom countered that the network of choice strategy could only be seen as pro-

competitive, as it could only be effected by making access to Telecom's network available on attractive terms that made self-provisioning uneconomic.

[144] We are not persuaded that the “network of choice” strategy is evidence that Telecom’s purpose was to deter competition in either of the two pleaded affected markets – the national wholesale market for backbone transmission services and the national retail market for end-to-end high speed data transmission services. To the extent that the “network of choice” strategy made using Telecom’s tails more attractive, it would, if anything, have increased the return on investing in a backbone network as the cost of linking to that network would be reduced.

*No price competition*

[145] The Commission referred to evidence that Telecom deliberately set out to price at a level that precluded TSPs competing on price alone in the retail market for data services. Mr Farmer pointed to a memorandum from Bruce Parkes, who headed Telecom’s Industry Services Unit (ISU), which was responsible for the development and sale of commercial products to other service providers. Mr Goodin worked under Mr Parkes in developing CDP. In a memorandum to Theresa Gattung, then Chief Executive Officer of Telecom, Mr Parkes said:

Our negotiations to date with carriers have been to treat them exactly like other large corporate customers ...

... carriers such as Telstra are obviously competitors in the retail market form any services but for data they are actually primarily resellers of our retail data services ... and as such are growing the market for our benefit and theirs.

Mr Goodin accepted in evidence that Mr Parkes’ philosophy was that there would not be price competition between Telecom and other TSPs, but only competition on service quality.

[146] Telecom’s response, underlining one of the crucial issues in this case, is that in data transmission, Telecom is not providing an essential component but a data circuit and is entitled to price accordingly. As we have said in another context, while that may well be the case in areas where rival access networks exist or are economic,

in areas where rival build cannot be economic, access to Telecom's network is a necessary input into the sale of data services.

#### *Absence of evidence*

[147] Mr Farmer submitted that the failure of Telecom to call evidence that an ECPR analysis had been carried out or to explain why it had not been carried out supported an inference that it had an anti-competitive purpose. He relied on what is sometimes referred to as the rule in *Jones v Dunkel* (1959) 101 CLR 298, but which the New Zealand Court of Appeal in *Ithaca (Custodians) Limited v Perry Corporation* [2004] 1 NZLR 731 at [153] described as:

... a principle of the law of evidence authorising (but not mandating) a particular form of reasoning. The absence of evidence, including the failure of a party to call a witness, in some circumstances may allow an inference that the missing evidence would not have helped a party's case. In the case of a missing witness such an inference may arise only when:

- (a) the party would be expected to call the witness (and this can be so only when it is within the power of that party to produce the witness);
- (b) the evidence of that witness would explain or elucidate a particular matter that is required to be explained or elucidated (including where a defendant has a tactical burden to produce evidence to counter that adduced by the other party); and
- (c) the absence of the witness is unexplained.

[148] In the course of his evidence, Mr Fraser indicated that he thought an ECPR analysis of proposed CDP pricing would have been carried out but Mr Goodin, who led the development of CDP, said that, although he was familiar with ECPR, he had "not had occasion to explore or apply the rule". It followed, argued Mr Farmer, that either no ECPR analysis was done or one was done without Mr Goodin being made aware of it. Neither of those ultimately responsible for the decision to introduce CDP – Mr Parkes and Ms Gattung – were called and no documents were discovered indicating that an ECPR analysis had been carried out. As both Mr Parkes and Ms Gattung were apparently available to give evidence, and there was no reason given why either could not do so, and in the absence of relevant documentation,

Mr Farmer submitted that an inference should be drawn that either no ECPR analysis was done by Telecom or, if an analysis was done, its results were unfavourable.

[149] We agree that in the circumstances the two inferences suggested by Mr Farmer are available but there is no rational basis for choosing one in preference to the other. And, if no ECPR analysis was done, we would not be prepared to conclude, as Mr Farmer submitted we should, that this was because Telecom did not intend that its CDP prices would be ECPR compliant.

[150] While this aspect of the evidence was left in an unsatisfactory state, we do not feel able to rely on it to make findings of an anti-competitive purpose.

### *Conclusion*

[151] In our view, the readily foreseeable effects of pricing two-tail circuits to TSPs above ECPR and, in many cases, above retail prices, is sufficient to support an inference that Telecom used its dominance for the pleaded purposes. The way in which Streamline and CDP were introduced and the statements of those responsible for their introduction are consistent with a strategy on the part of Telecom to deny rival TSPs access to data tails at prices that would permit them to utilise and develop their own networks for the purpose of data transmission.

### **Limitation issues – Telecommunications Act 2001**

[152] For Telecom it was submitted that the extent to which its conduct can be examined and remedies granted is constrained by legislation and settlement agreements reached by the parties. The Commission is unable to seek a pecuniary penalty for breaches occurring before 18 March 2001, though it maintains it can seek a declaration in relation to prior breaches. Telecom's position is that its conduct can only be scrutinised for the period between 18 March 2001 and 19 December 2001 when the Telecommunications Act 2001 came into force.

[153] Mr Shavin argued that on the Telecommunications Act coming into force, Telecom ceased to be able to take advantage of any market power over high speed data transmission services. He contended that the Act expressly and by necessary implication excluded review under the Commerce Act of Telecom's conduct subsequent to its passing. He relied on provisions in the Telecommunications Act which permit an access-seeker to apply to the Commission for a determination of the price of HSDT services and which exclude from review under the Commerce Act such determination or any matter necessary to give effect to such a determination.

[154] The right of an access-seeker to apply for a determination is in s 20 of the Telecommunications Act which provides:

### **Application**

- (1) An access seeker or an access provider of a designated access service or specified service may apply to the Commission for a determination of all or some of the terms on which the service must be supplied during the period of time specified in the application.
- (2) For the purposes of subsection (1), the terms on which the service must be supplied—
  - (a) may, in the case of a designated access service, include the price payable by the access seeker for the service; and
  - (b) must, in the case of a specified service, exclude the price payable by the access seeker for the service.

[155] A review under the Commerce Act of a determination under s 20 is excluded by s 63 of the Telecommunications Act which provides:

### **Application of Commerce Act 1986**

Part 2 of the Commerce Act 1986 does not apply in respect of a determination made under this Part or any matter necessary for giving effect to a determination made under this Part.

[156] TelstraClear applied under s 20 of the Telecommunications Act for determination of price and non-price terms for supply by Telecom to TelstraClear of a range of retail services. In Decision 497, the Commission concluded (at [559]) that Telecom faced limited competition in the retail market for data services in nonmetropolitan areas. It determined that in non-metropolitan areas, Telecom should

wholesale specified data services to TelstraClear at its standard retail prices less 16%.

[157] Decision 497 is not concerned with access to or the pricing of data tails. The determination was concerned with the designated access service of “retail services offered by means of Telecom’s fixed telecommunications network as defined in sub-Part 1 of Part 2, No. 2 of Schedule 1 of the Act”. As the determination records at [64], as Telecom only sold end-to-end data services at the retail level, a customer could not purchase separately the components of data services, such as data tails. Accordingly, the relevant wholesale service is the end-to-end data service; its individual components are excluded.

[158] Telecom argued that s 63 of the Act nevertheless applied to Decision 497 to exclude the pricing of data tails from consideration in this proceeding. Mr Shavin submitted that the fact that Decision 497 deals with resale of an end-to-end data circuit does not assist the Commission, as it pleads that CDP pricing offered TSPs the ability to resell Telecom’s high speed data transmission services. He also submitted that this service is technically indistinguishable from data tails.

[159] We do not agree. The Commission’s claim focuses on CDP pricing of data tails; it is not concerned with the pricing of circuits for resale as an end-to-end retail service. The pricing of data tails as a component of the retail service is expressly excluded from Decision 497. Section 63 can have no application.

[160] Mr Shavin also referred to s 64 of the Telecommunications Act under which, as earlier noted (at [32] above), the Commission was required to undertake a review of whether access to unbundled elements of Telecom’s local loop network should be regulated. Mr Shavin argued that the UPC service which followed the Commission’s report was effectively extracted from Telecom in order to avoid a recommendation that unbundled data access be designated. By this means the exercise of regulatory power supplanted Telecom’s market power.

[161] We are not persuaded that the Telecommunications Act and its aftermath had the consequences contended by Telecom. In particular, we are satisfied that its

conduct subsequent to the passing of the Act is properly subject to scrutiny under the Commerce Act.

[162] While the Telecommunications Act plainly imposes constraints on Telecom in relation to designated access services, there is nothing to indicate that it provides (or provided) any material constraint in relation to the pricing of data tails. There was no change to CDP pricing after the Act came into force. It was recognised that the decision not to specify data tails as a designated access service may give rise to competition concerns. A ministerial paper submitted to the Ministerial Inquiry into Telecommunications in November 2000, acknowledged that data tail access issued could “prove to be a competition problem”. It is clear there was no expectation that the legislation would remove the need for oversight in that sector. While the Commission’s review under s 64 of the Telecommunications Act led to the introduction of UPC pricing, that was because of the threat of further regulation. The existing legislation had no discernible effect on Telecom’s conduct.

### **Settlement agreements**

[163] We noted earlier (at [30]) that Clear and Telstra (and other TSPs) entered into settlement agreements with Telecom. Neither agreement made any change to existing CDP pricing offers. However, for Telecom it was submitted that the “detail and solemnity” of the terms of the Telecom/Clear agreement are critically relevant. In particular, Mr Shavin referred to the substantial benefits which flowed to Clear under the agreement and the agreement of the parties that:

... this agreement has been freely concluded as one of a suite of agreements which are to be entered into contemporaneously by the parties and which have been freely concluded in good faith as a ‘package deal’, with give and take, between the parties as substantial commercial entities and is entirely lawful and enforceable and the parties have so been advised.

[164] For Telecom it was submitted that in the circumstances any claim that Telecom unlawfully exercised its market power vis-à-vis Clear must end on 1 October 2000 when the agreement came into force, and the agreement remains relevant in considering Telecom’s exercise of market power in relation to other TSPs after that date.

[165] We do not think the settlement agreement with Clear can be accorded this level of significance. Plainly, it involved compromises for both parties. We can only speculate what they were. The fact that Clear agreed to a continuation of CDP pricing for the purpose of settling a wide range of issues is irrelevant to the critical question of whether the prices were ECPR compliant in the first place, and the implications for the competitive process if they were not.

## **Remedies**

### *Declaration*

[166] The Commission issued proceedings on 18 March 2004. It seeks a pecuniary penalty in respect of conduct from 18 March 2001 to the introduction of UPC pricing. It accepts that the Court cannot order a pecuniary penalty for the earlier period of the alleged price squeeze because of the provisions of s 80 of the Act which relevantly provides:

#### **80 Pecuniary penalties**

(1) If the Court is satisfied on the application of the Commission that a person—

(a) has contravened any of the provisions of Part 2 of this Act;  
or

...

the Court may order the person to pay to the Crown such pecuniary penalty as the Court determines to be appropriate.

...

(5) Proceedings under this section may be commenced within 3 years after the matter giving rise to the contravention was discovered or ought reasonably to have been discovered. However, no proceedings under this section may be commenced 10 years or more after the matter giving rise to the contravention.

[167] Although unable to seek a pecuniary penalty in respect of the earlier period, the Commission maintains, however, that it is entitled to a declaration that Telecom's conduct during the earlier period was in contravention of the Act.

Ms Coumbe, who argued the Commission's case on this issue, submitted that the limitation provision in s 80(5) applies only to the recovery of pecuniary penalties. The Commission's position is that the Court has inherent jurisdiction to grant a declaration that there has been a contravention of the Act and that jurisdiction is not subject to any limitation period.

[168] Telecom maintains that the Court has no power to grant a declaration in respect of the earlier period. If there is jurisdiction to grant a declaration, it is submitted the Court's discretion should be exercised against doing so.

#### *Source of jurisdiction*

[169] There is inherent jurisdiction to make declarations and the Declaratory Judgments Act 1908 enables declarations to be made whether or not any other relief is sought or available. Section 2 provides:

No action or proceeding in the [High Court] shall be open to objection on the ground that a merely declaratory judgment or order is sought thereby, and the said Court may make binding declarations of right, whether any consequential relief is or could be claimed or not.

In *Peters v Davison* [1998] NZAR 309, the Declaratory Judgments Act and the Court's inherent jurisdiction were treated as two distinct sources of jurisdiction by Smellie J. However, it seems clear that s 2 does not enlarge the jurisdiction of the Court. It merely provides that no objection can be made on the ground that only a declaration is sought – see the remarks of Viscount Dilhorne in *Gouriet v Union of Post Office Workers* [1978] AC 435 at 495; see also the discussion in *Johnston v Johnston* (1990) 2 PRNZ 323.

### *Scope of jurisdiction*

[170] A declaration may be made where a legal right is in issue. In *Gouriet v Union of Post Office Workers*, Lord Diplock noted at 501 that the limits to the jurisdiction are inherent in the nature of the relief: a declaration of rights. He went on to say:

The only kinds of rights with which courts of justice are concerned are legal rights; and a court of civil jurisdiction is concerned with legal rights only when the aid of the court is invoked by one party claiming a right against another party, to protect or enforce the right or to provide a remedy against that other party for infringement of it, or is invoked by either party to settle a dispute between them as to the existence or nature of the right claimed. So for the court to have jurisdiction to declare any legal right it must be one which is claimed by one of the parties as enforceable against an adverse party to the litigation, either as a subsisting right or as one which may come into existence in the future conditionally on the happening of an event.

[171] Lord Wilberforce said at 483:

Since, as I understand, others of your Lordships intend to deal fully with this argument and with the authorities, I shall content myself with saying that, in my opinion, there is no support in authority for the proposition that declaratory relief can be granted unless the plaintiff, in proper proceedings, in which there is a dispute between the plaintiff and the defendant concerning their legal respective rights or liabilities either assert a legal right which is denied or threatened, or claims immunity from some claim of the defendant against him or claims that the defendant is infringing or threatens to infringe some public right so as to inflict special damage on the plaintiff.

[172] *Gouriet* was treated as stating the law in New Zealand in *Re Chase* [1989] 1 NZLR 325 – see, in particular, the judgments of Cooke P at 334 and Henry J at 343. The passages from *Gouriet* set out above were quoted with approval in *Gazley v Attorney-General* (1995) 8 PRNZ 313 (CA) at 318.

[173] It is clear, however, that the legal right involved does not have to be one which is vested in the parties themselves. In *Re S (Hospital Patient: Court's jurisdiction)* [1996] 1 Fam 1, Millet LJ said at 22, after referring to the passage from Lord Diplock's speech in *Gouriet*, that it can no longer be taken to be an exhaustive description of the circumstances in which declaratory relief can be granted today. He went on to say:

Provided that the legal right in question is contested by the parties, however, and that each of them would be affected by the determination of the issue, I

do not consider that the court should be astute to impose the further requirement that the legal right in question should be claimed by either of the parties to be a right which is vested in itself.

[174] In similar vein, the Court of Appeal in *Peters v Davison* [1999] 2 NZLR 164 rejected the proposition that the Court can make a declaration only if there are rights and duties of, and owed between, relevant parties (at 187). Among its reasons were what it described as the “well established rule” that a private individual who will sustain injury as a result of a public wrong may bring proceedings.

[175] There is, then, a broad jurisdiction to grant a declaration, summed up in this way by Lord Lane in *Imperial Tobacco Ltd v Attorney-General* [1981] AC 718 at 750:

Anyone is on principle entitled to apply to the Court for a declaration as to their rights unless statutorily prohibited expressly or by necessary implication.

#### *Declarations in Commerce Act cases*

[176] There is nothing in the Commerce Act to indicate that this broad jurisdiction is not available when rights under the Act are in issue. It is not one of the suite of remedies prescribed for breaches of the Act. And it may be thought that the specific provision in s 5(4) that a declaration may be sought against the Crown tells against a general jurisdiction under the Act to grant relief by way of declaration. However, we agree with McGechan J who said in *Commerce Commission v Fletcher Challenge Ltd* [1989] 2 NZLR 554 at 611:

I acknowledge these points, but in the end I am not persuaded. The declaration is a common and useful remedy, gaining steadily greater currency under modern conditions. I do not see good policy reasons for Parliament to have gone to the extreme of denying the jurisdiction itself in the context of the Commerce Act enforcement. Any fears, if they are real, as to disadvantages of declarations in that context are matters which could be covered by proper exercises of discretion and I have some confidence Parliament would have been matters in that light. Section 5 is a special regime which does not have necessary links with Part VI enforcement. . .

The reasoning in *Commerce Commission v Fletcher Challenge* was applied in *Commerce Commission v Sweetline Distributors Ltd* (2000) 6 NZBLC 103, 130 and

*Commerce Commission v Telecom Mobile Ltd* [2004] 3 NZLR 667, to contraventions of the Fair Trading Act 1986.

[177] The Commission also relied on *Tobacco Institute of Australia Ltd v The Australian Federation of Consumer Organisations Inc* (1993) 113 ALR 257 (FCA). In that case, the Federal Court had granted an injunction under s 52 of the Trade Practices Act 1974 in relation to an advertisement that was found to constitute misleading or deceptive conduct in trade or commerce in contravention of s 52 of the Act. The full Court of the Federal Court upheld the finding of a contravention but held that the exercise by the first instance Judge of his discretionary power to issue an injunction was wrong in law. The Court held, however, that notwithstanding the absence of an express power in the Trade Practices Act to grant a declaration, there was jurisdiction to do so for the purpose of showing the Court's disapproval of conduct that contravened the Trade Practices Act.

[178] The jurisdiction to grant a declaration was based on s 21 of the Federal Court of Australia Act 1976 (Cth) which provides:

- (1) The Court may, in relation to a matter in which it has original jurisdiction, make binding declarations of right, whether or not any consequential relief is or could be claimed.
- (2) A suit is not open to objection on the ground that a declaratory order only is sought.

[179] It was argued that the Court had power only to make declaratory orders declaring *inter se* the rights of the parties to the litigation and that an order declaring the conduct of the respondent to be misleading and deceptive is not declaratory of the rights of the applicant. Sheppard J held that the jurisdiction to make a declaration was derived from the jurisdiction conferred on the Court by s 80 of the Trade Practices Act which gave the Court jurisdiction to grant injunctive relief. He said at 266:

... Here the respondent was able to sue for injunctive relief because of the express provisions of s 80 of the Act which empowered the court to entertain such an action, although brought by an ordinary citizen. Section 21 of the Federal Court Act empowers the court to make a declaration of right in a matter in which it has original jurisdiction. The court has original jurisdiction because of the provisions of s 80. It is therefore empowered, if it is otherwise appropriate to do so, to make a declaration of right in such a

case whether or not the injunctive relief is also granted. The declaration, if made, will be a declaration of right because the right which will be declared will be a public right, namely the right of the public not to be misled or deceived by factual statements in an advertisement concerning the effects of passive smoking.

[180] In his judgment, Hill J focused on whether a declaration that the conduct of the respondent was misleading and deceptive was a declaration of right in terms of s 21. He appears to have assumed that declaratory relief was available under the Trade Practices Act. Foster J agreed with the judgments of both Sheppard and Hill JJ.

[181] In the *Tobacco Institute* case, the Court was considering whether it had “original jurisdiction” as required by the statute conferring jurisdiction. Where the inherent jurisdiction of the Court is invoked in relation to a public right created by statute, the question becomes whether, as a matter of construction, jurisdiction to grant declaratory relief arises in relation to that right.

[182] In our view, the relevant provisions of the Commerce Act show a clear legislative intent to confine any claim for relief to the three-year period following discovery of the matter giving rise to the contravention (or the time at which discovery might reasonably have occurred). Jurisdiction to hear and determine contraventions of Part 2 of the Act is conferred on this Court by s 75(1) which relevantly provides:

### **Jurisdiction of High Court**

- (1) In accordance with this Part, the High Court shall hear and determine the following matters:
  - (a) in the case of contraventions of Part 2,—
    - (i) proceedings for the recovery of pecuniary penalties under section 80;
    - (ii) applications for injunctions under section 81;
    - (iii) actions for damages under section 82;

[183] The Court’s jurisdiction to hear and determine proceedings for contraventions of Part 2 is dependent on the proceedings seeking one or more of the forms of relief available under s 75(1)(a). If there is no right to seek such relief, the Court has no

jurisdiction to hear the proceeding. It follows that there is no jurisdiction to make a declaration in respect of a contravention which cannot be the subject of proceedings for a pecuniary penalty, injunction or damages.

[184] The scheme of the statute tells against an interpretation which would permit conduct to be examined for the purpose of declaratory relief for an indefinite period. Rights to relief, other than by way of injunction, under Part 6 of the Act are generally subject to the three-year time limit. Section 82(2) imposes the same limitation period on actions for damages for contraventions of Part 2. Limitations on proceedings for contraventions of s 74D (cease and desist orders), Part 3 (business acquisitions) and Part 4 (control of prices) are generally three years, the exception being an application for an order for divestiture under s 85(2) which must be made within two years. In our view, it would be anomalous and contrary to the intention of the Act if actions for a declaration alone could be undertaken without limit in relation to contraventions which could not be the subject of any other form of relief under the Act.

[185] It would also be contrary to the purposes of a limitation provision, identified as follows, in the context of the Commerce Act, by Fisher J in *Commerce Commission v Roche Products (New Zealand) Ltd* [2003] 2 NZLR 519 at [33]:

Although the purposes of limitation provisions have been variously expressed, I think it would be generally accepted that they include the protection of defendants against those difficulties of proof which can be expected to mount with the passage of time. Providing prosecutors and plaintiffs with an incentive to bring proceedings within a reasonable time enhances the quality of justice by encouraging fresh evidence. A second purpose is to avoid the time, cost, and disruption, of reopening those matters whose social significance will have diminished with the passage of years. A grocer's indignation that last year's bill was not paid will usually have abated 20 years on. A third purpose is to promote certainty. With the passage of years, potential defendants will be increasingly justified in ordering their lives in reliance upon the status quo. In that regard I accept Ms Callinan's submission that one of the purposes implicit in s 80(5) of the Commerce Act is to promote commercial certainty. A company's exposure to penalties and civil claims for periods that are open-ended could represent an undesirable disincentive for its future investors and creditors who may be entirely innocent of the original misconduct which contravened the Act. A fourth purpose can be the striking of a reasonable balance between the expansion of liability for an identified group, on the one hand, and placing temporal limits on their exposure, on the other (see in that respect *Murray v Eliza Jane* at pp 258 – 259).

[186] The Commission relied on *Sisters of Mercy (Roman Catholic Diocese of Auckland Trust Board) v The Attorney General* HC AK CP219/99 6 June 2001 Randerson J, where it was held that the Limitation Act 1950 did not apply to exclude jurisdiction to grant declaratory relief under the Judicature Amendment Act 1972. However, as Mr Shavin pointed out, the question in this case is not whether the Limitation Act applies but whether, as a matter of statutory construction, there is jurisdiction to grant declaratory relief in the absence of an enforceable right.

[187] We conclude that the Commission is entitled to relief, both declaratory and pecuniary, only in respect of Telecom's conduct after 18 March 2001.

## **Conclusion**

[188] Telecom used and/or took advantage of its dominant position/market power from 18 March 2001 until late 2004 (when Telecom introduced a UPC service) for the purposes of deterring potential or existing competitors in the wholesale market for backbone transmission services and the retail market for end-to-end high speed data transmission services.

[189] The issue of remedy by way of pecuniary penalty is reserved for separate consideration. The parties may seek a conference for the purpose of making any necessary directions on that issue and in relation to costs.

.....  
Rodney Hansen J

.....  
Professor Martin Richardson

## APPENDIX 1

### GLOSSARY

ATM	Asynchronous Transfer Mode
CBD	central business district
CBR	constant bitrate
CDP	Carrier Data Pricing
CIR	Committed Information Rate
DCS	digital cross-connect switches
DDS	digital data services
DSL	digital subscriber line
DSLAM	digital subscriber line access multiplexer
DSTN	Digital Services Transport Network
ECPR	Efficient Component Pricing Rule
FR	Frame Relay
HSDT	high-speed data transmission
IP	Internet Protocol
NTU	Network Terminating Unit
PIR	Peak Information Rate
POP	point of presence
PSTN	Public Switched Telephone Network
SWA	stacked wideband access
TLoC	Telecom List of Charges
TSP	Telecommunications Service Provider
UPC	Unbundled Partial Circuit
VBR	variable bitrate
WIN	Wholesale Integrated Network